

Current
Policy No. 272

Energy Security and International Preparedness

March 23, 1981



United States Department of State
Bureau of Public Affairs
Washington, D.C.

U. S. DEPOSITORY DOCUMENT

MAY 05 1981
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Following is an address by Edward L. Morse, Deputy Assistant Secretary for International Energy Policy, before "The Outlook for Crude Oil" conference sponsored by Energy Bureau, Inc., in Houston, Texas, on March 23, 1981.

The outlook for crude oil is a subject that has never been more timely or so difficult to deal with. The last 2 years have been turbulent ones for the oil markets. We have seen disruption, revolution, and war in the Persian Gulf. At home, we have moved quickly from a complex regulatory environment to complete crude oil decontrol. On the international market, crude oil prices have more than doubled since the beginning of 1979. International systems of adjustment and emergency preparedness were thus tested by political events. Our conclusion is that they need to be strengthened and improved.

If the past is prologue, can we expect more disruption in crude oil supplies in the years ahead? Although no one can really predict, my answer would be "yes." I hope I am wrong. In today's oil market, stability has become a scarce commodity, although there are signs of hope. Given the likelihood that we may face disruptions, therefore, we must both learn from the past and create for the future. We need to make an innovative effort to fashion new and improved mechanisms to increase energy security without abandoning—indeed by building on—the tested elements of market flexibility.

It is my view that in the years ahead energy market pressure and crises requiring international cooperation will

come from any one of three quarters. One source is the ever-present risk of supply disruption associated with political conflict. Today's continuing war between Iran and Iraq and the 1973 Arab-Israeli war are but two leading examples. I would also include in this category threats of destination restrictions for political reasons, for example, by Nigeria in carrying out its policy toward South Africa or by other producers; domestic clashes over energy policy like the recent one between Alberta and Ottawa which has now resulted in a shutting in of 100,000 barrels per day of production; and other nonviolent political disputes as factors in determining oil production and exports. Nor is the problem limited to crude availability alone. European dependence on the Soviet Union for substantial amounts of natural gas holds the seeds of future problems as well.

A second source of disruption is sure to be social upheaval. This may remind many of the strikes and chaos of Iranian revolution and its impact on oil production and exports in late 1978 and 1979. We need to bear in mind that the overwhelming proportion of crude oil traded internationally comes from developing areas of the world. It is precisely these areas that are undergoing unpredictable processes of modernization, which is inevitably accompanied by internal social stress. Examples are India's continuing problem in maintaining oil production in its Assam Province in the face of strikes and sabotage, problems of terrorism and sabotage also exist in Turkey, and the continuing threat of similar incidents almost anywhere. Nor are industrial countries immune to this problem, as

coal strikes in Britain, Australia, and the United States during the last 5 years should remind us.

One other source of market pressure with potential for erupting into an unnecessary price spiral is the potential national shortfalls caused by sudden demand surges in a market narrowly in balance. The unfortunate fact is that crude oil production capacity is not being expanded in pace with predicted paths of energy demand, and there is very little we can do about this in the short run. A rapid and simultaneous economic recovery in the major OECD [Organization for Economic Cooperation and Development] countries could therefore quickly lead to crude shortages and price pressures without any immediate available supply response. Coincidental cold winters hold some of the same risks, although healthy stock levels can obviate much of that worry.

Together with industry . . . we can design an international energy policy that is resilient and effective and build the framework of energy security that is needed to insure renewed and sustained economic growth at home and abroad.

Viewing these problems and our lack of adequate preparedness, Secretary Haig told the Senate Foreign Relations Committee that the industrial democracies "have not yet built an effective program for dealing with the energy crisis." We do have one element, the emergency oil allocation system of the International Energy Agency (IEA). Never implemented, but tested in several full-scale simulations, the IEA-sharing system is designed to counter the catastrophic shortfall—over 7% of combined IEA oil imports. This mechanism can and should be improved even though disruptions of this magnitude remain improbable.

In the oil markets in the years ahead, much smaller crude shortfalls, say some 2%-4% of IEA consumption, are much more likely—some would argue inevitable. They can lead to sharp spot market price spikes, later ratified by the Organization of Petroleum Exporting Countries (OPEC). We believe, therefore, that we need to improve our collective preparedness for these smaller shortfalls, and we are just beginning the process. Before discussing the ongoing work, however, let me review some lessons from the past that are guiding our current studies.

Iranian Revolution

In 1979, Iranian domestic upheaval caused sharp and fluctuating reductions of oil production at a time when OECD stocks were well below normal levels. For one brief period Iranian production, which 6 months earlier hovered near 6 million barrels per day (b/d), completely ceased. You are all familiar with the price consequences of that situation. In retrospect, I think we made three basic mistakes.

First, the IEA may have contributed to alarm at the early stages of the crisis by flatly projecting a 2 million b/d shortfall, before, during, and after the full response of other producers was known. The then-U.S. Secretary of Energy, by publicly and frequently announcing an inflated national supply gap, himself effectively inspired com-

panies to bid up the price of available supplies first on the spot market and later in term contracts.

Second, the IEA decision in March 1979 to cut imports by 2 million b/d (5% of demand) was not effective and involved no binding commitments on the part of governments.

Third, substantial price pressure was caused through a defensive stockbuild by governments and companies, averaging 1 million b/d during 1979 and 1980. Indeed, in retrospect the pressures on the market in 1979 and early 1980 were demand led much more than they resulted from an effort by OPEC to squeeze consumers.

These mistakes were compounded by a general refusal to recognize the substantial structural changes that had taken place in the international energy market. The percentage of crude distributed by the majors (the seven largest international oil companies) declined from close to 90% to nearer to 50% as sales to third-party customers became discretionary or were eliminated and replaced by rapid growth of government-to-government sales. Two problems resulted. First, flexibility in the distributional system was severely con-

strained. Second, the proliferation of State-owned oil companies in consuming countries meant more players were involved in efforts to secure adequate stocks. Thus on an international basis, the overall minimum desirable stock level was substantially higher than it had been when the international role of the majors was more predominant.

Clearly, the 1979 experience points to the critical importance of adequate stock levels to disruption management. So too does it point to the need for good information early in the game and credible cooperation between leading oil importers.

Impact of Iran-Iraq War

Last year, when war broke out between Iran and Iraq, we knew what was at stake. About 3.8 million b/d in crude exports were lost to the world market soon after war broke out. No one knew how long the war would last; although the general view was that it would be short. Some feared wider hostilities imperiling exports from other Persian Gulf ports or traffic through the Straits of Hormuz. If the spot market were to have become heated, a renewed price bulge would have ended hopes for economic recovery in 1981. And, given the perceived shortcomings of the IEA in 1979, in some ways the very framework of international energy cooperation was also on trial.

Our task last year was to use wisely our initial assets—high stocks and soft demand. Meeting within a week of the outbreak of the war, the IEA Governing Board agreed to absorb crude shortfalls with stock drawdowns and to "urge and guide" all market participants to refrain from any abnormal spot market purchases. These were first steps, taken to avoid any market runup while we waited to see how long the conflict would last.

Another problem was addressed. Iran and, in particular, Iraq had shown a proclivity to encourage government-to-government sales. In many instances these sales represented a very high proportion of individual country imports, in some cases virtually all imports. The crisis therefore had a selective direct impact, affecting countries like France, Brazil, Turkey, and Italy substantially but scarcely affecting the United States or Germany. Producing countries quickly moved to do their part to make up lost supply. Saudi Arabia, in particular, raised its exports by 1.5 million b/d over its preferred production level of 8.5 million b/d and directed its incremental

production to those of Iraq's customers most severely affected. Consuming countries recognized their own responsibilities as well, as the war dragged on longer than previously had been anticipated.

At a ministerial-level meeting December 9, IEA members reaffirmed and extended these decisions, clarified the spot market activities that were "undesirable" for IEA members, and committed even relatively unaffected member countries to draw down stocks to achieve a balance between oil market supply and demand. This was to make more oil available through the market to countries in and out of the IEA facing serious shortfalls.

I would not attribute the relative calm of the spot market during the crisis solely or even mostly to the IEA's pronouncements, but the IEA moves did help to solidify and sanction the company decisions to refrain from spot market purchases. The IEA helped to set the psychological climate. Company decisions, as always, were taken on sound business grounds. Since OECD economies were flat or in recession, many companies had limited immediate needs for oil, given high stocks, and no company wished to become a "negative example." In this respect the severe stigma attached to the behavior of some companies in 1979, particularly the Japanese, played a major role in keeping companies off the spot market.

We realized that certain countries were particularly dependent on Iraqi and Iranian supplies, and special efforts were needed to make sure that these countries would have access to other sources of crude. The most urgent such case was Turkey, which depended on the two combatants for 70% of normal crude imports and where financial stringency had prevented the accumulation of more than 40 days' stocks.

At Turkey's request, IEA Executive Director Lantzke coordinated an informal effort to analyze Turkey's needs and to examine how the shortfall in oil supplies might be made up. The United States and other IEA members contacted oil companies to inform them of Turkey's needs and to suggest that any available and appropriate crude cargoes be offered to Turkey. Substantial amounts of oil were offered in this informal way. As it happened, the timely resumption of Iraqi pipeline shipments, together with purchases from Iran, allowed Turkey to meet its current needs.

Looking at the oil market as we move out of the winter heating season, we can say the situation is improved. Growing export volumes from Iran and Iraq in the face of continuing weak demand due to recession and to a surprising amount of price-induced conservation allow the market to balance. Yet we must continue to be cautious. The exposed Iraqi pipelines through Turkey and Syria can be interrupted again. A too-rapid effort to rebuild depleted stocks on the part of IEA members could lead to price pressure in the open market. And in light of these needs, early production cutbacks by surplus Persian Gulf producers could also cause difficulties.

Planning for the Future

It is in this uncertain environment that we find ourselves developing an international energy policy for the future. I am not sure any two people would agree on what an adequate degree of energy security is, but I am confident that all would agree that generally we need more of it.

For the United States, protection against unforeseen crude oil shortfalls must begin with an effective strategic petroleum reserve. Earlier this year, we began a policy of open solicitations for reserve purchases, subject to budgetary considerations, of course. It is not clear how much oil the Department of Energy will be able to purchase through the end of the year, but we are very encouraged by the offers we have received so far. Our intermediate goal for an effective national reserve remains 500 million barrels; our long-term goal is 1 billion barrels.

The strategic petroleum reserve is a foundation for crude oil security. We anticipate it would be used in response to a major oil supply interruption and in the framework of an IEA response. But it is not the all-purpose instrument some people believe it is. It is not a price stabilization mechanism or buffer stock to be used to intervene in markets. It is not to be used to cover small-scale, regional, or short-lived supply interruptions, where private stocks, demand restraint, fuel switching, or private markets can do the job.

As important as the building of an effective national reserve is, therefore, we cannot ignore other measures to improve energy security and preparedness. With the Iran-Iraq conflict, IEA members gained greater experience with informal cooperative measures. We can

build on this and earlier experiences to fashion contingency measures for less than catastrophic crude supply interruptions that minimize marketplace intervention but prevent unjustified (and long-lasting) crude oil price increases.

We are just beginning an in-depth review of international energy policies in this area, in the U.S. Government and in a high-level ad hoc IEA group. Let me mention a few of the ideas which are sure to be considered.

Oil stocks in private hands are an important part of our energy security system. I believe that the informal stock consultations initiated following the outbreak of the Iran-Iraq war helped establish a psychological climate that encouraged stock drawdowns in the early stages. We are reviewing our stock management and consultation policy to see whether improvements can be made. It might be advantageous, for example, if all IEA nations increased private stock levels beyond the current required minimum of 90 days of imports.

There is, of course, a limit to industrial nations' ability to use public and private stocks to cushion supply disruptions of long duration. The role of demand restraint in counteracting sustained oil supply shortfalls is indispensable. The United States may now rely to a larger extent on the free play of market forces to distribute oil domestically during a shortfall, but we must not underestimate the value of coordinated commitments by industrial countries to restrain oil consumption in a crisis. We must examine the possible use of such domestic policy measures as disruption fees or taxes and other market-based demand restraint measures, perhaps on a regional basis.

We have, however, too long been oriented to demand-side responses in our efforts to deal with disruptions. The supply-side offers promising avenues to pursue as well. It may be useful, for example, to have surge capacity for petroleum and natural gas and expanded storage for such fuels as natural gas. The natural gas shortfall in the New England area this winter points to the need for greater preparedness. Obviously, serious policy issues, including a liquefied natural gas import policy and price decontrol program, are involved, and the Administration's review of these issues is only beginning. We need to accelerate the development of nuclear energy by streamlining licensing procedures, by creating a climate of political support for nuclear energy, and

by fostering appropriate marginal cost pricing for electricity. We also need to reduce rapidly all supply-side restraints on coal utilization.

We need to examine what public policies are appropriate to encourage the construction and expansion of dual-fired industrial facilities. There are many industrial processes where alternate fuels are feasible, and greater fuel-switching capability can help us offset small market disruptions.

I mentioned the importance of accurate information on a continuing basis. As you know, the U.S. Government and the IEA each request a wide range of information from the oil industry on a regular basis. We are taking a hard look at all these information-gathering efforts to eliminate duplication and to see what is truly necessary. High on my list of priorities is preserving the good oil company cooperation with the IEA that we presently have. This is fundamental to the oil-sharing system. I recently testified in Congress to request that the Energy Policy and Conservation Act Section 252 antitrust defense for this type of activity be extended for several months to allow us to complete our review and make proposals for amendment to the present law.

All these policies and more will be needed to improve the state of American energy security. Meaningful energy security, however, requires more than contingency planning. It requires long-term efforts to enhance supply as well. We must make a determined effort to develop new sources of conventional and nonconventional energy at home and abroad. Here the record is good and getting better. U.S. energy production is up, coal output quite substantially. Price decontrol will help justify marginal oil and gas development and secondary and tertiary production techniques. Accelerated leasing of Federal lands will also provide scope for significant production increases. Investments in synthetic-

fuels technologies are up and some exciting concepts are being explored. The President is committed to renewed attention to nuclear energy's potential.

Investment Environment

In closing, a cursory review of efforts to enhance conventional energy supplies cannot ignore the international investment environment. We are justifiably proud of the record level of drilling activity in the United States today, but this level reflects the more favorable climate here for exploration and development more than it does the promise of substantial geologic potential. The sad fact is that some of the most promising areas for development of conventional energy sources are not being developed as they should be.

In some cases, like the Middle East and the North Sea, this results from intentional governmental decisions to conserve or to restrict production through taxation. We need to inspire innovative processes to stimulate the development of higher productive capacities. Elsewhere, as in our neighbor to the north, discriminatory investment policies, which favor domestic over foreign companies, run the risk of reducing substantially the optimal development of energy capacity. We need to remind the world that foreign companies are not the bearers of economic dependency, as some abstract social theories portray them. Rather, capital, which is willing to bear risk of exploration and development regardless of its national origin, can be harnessed for the well-being of all concerned.

There is, as well, the sad fact that in many developing countries it is politically unacceptable for foreign companies—which have the required expertise and capital for exploration and development—to carry out work without the

equity participation of domestic interests, which do not have the financial ability to invest alone. We need to examine ways to overcome this political barrier, perhaps by fostering the mutually advantageous cooperation of oil companies, national governments, private banks, and multilateral lending institutions. We are now examining this issue to see if such proposals make sense for U.S. policy and U.S. firms.

We need also to recognize the impediment to energy resource development, especially in developing countries, which results from incompatibilities between fiscal regimes here and abroad. Here too we need to be creative in developing acceptable ways to reconcile these differences and thereby enhance investment in exploration and development.

Finally, through the IEA's Standing Group on Long-Term Cooperation, which I chair, we are seeking to encourage more effective energy policies in all industrial countries. Jointly, IEA nations will be reducing the role of oil in their economies and moving to encourage new production of oil and alternative sources.

We have a long road ahead, and the risks of renewed crude oil supply problems are endemic to today's world. Together with industry, however, we can design an international energy policy that is resilient and effective and build the framework of energy security that is needed to insure renewed and sustained economic growth at home and abroad. ■

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